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IN THE

Supreme Court of the United States

OCTOBER TERM, 1940.

Nos. 408, 409.

CITY BANK FARMERS TRUST COMPANY, as Trustee of a Trust Under the Last Will and Testament of Angier B. Duke, Deceased, for the Benefit of ANTHONY NEWTON DUKE,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent,

and

CITY BANK FARMERS TRUST COMPANY, as Trustee of a Trust Under the Last Will and Testament of Angier B. Duke, Deceased, for the Benefit of ANGIER B. DUKE, JR.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF FOR PETITIONERS.

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BRIEF FOR PETITIONERS.

Opinions Below.

The majority opinion (R. 36), the concurring opinion (R. 42) and the dissenting opinion (R. 43) of the United States Board of Tax Appeals are reported in 39 B. T. A. 29. The opinion of the Circuit Court of Appeals (R. 176) is reported in 112 F. (2d) 457.

Jurisdiction.

The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925. The judgments of the Circuit Court of Appeals were entered on June 12, 1940 (R. 181-182). The petition for certiorari was filed September 9, 1940, and granted February 10, 1941.

Questions Presented.

(1) Are the customary commissions of a testamentary trustee, computed in accordance with State law, deductible in computing the net taxable income of the trust estate, as "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business"?

(2) Is it a valid objection to the allowance of such trustee's commissions as "ordinary and necessary expenses" that they were computed on the basis of and paid out of the corpus of the trust?

The Statute.

There are involved the following provisions of the Revenue Act of 1928:

> "Sec. 23. Deductions from Gross Income.
>
> In computing net income there shall be allowed as deductions:
>
> (a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *."

"SEC. 24. ITEMS NOT DEDUCTIBLE.

(a) *General Rule.*—In computing net income no deduction shall in any case be allowed in respect of—

(1) Personal, living, or family expenses;

(2) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate;

(3) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made; * * *."

The cases involve also a consideration of Section 285 of the Surrogate's Court Act of New York, which prescribes the method of computing and paying trustees' commissions and which for the convenience of the Court is set forth in an appendix to this brief.

The Facts.

The trusts were established under the will of Angier B. Duke, a New York decedent, one for the benefit of each of his two sons (R. 65). The trustee of each trust (the petitioner) was authorized to apply income for the support and education of a son and was directed to accumulate all income not so used until the son reached his majority, whereupon the accumulations of income were to be paid over to him, the principal to be continued in trust for the benefit of the son and his descendants (R. 75-77).

The trusts were set up on February 26, 1926, by transfer from the executor of securities of the market

value of over $3,800,000 in the case of each trust (R. 71, 84, 86).

During the tax year (1931) the combined trust assets comprised a diversified list of securities aggregating over $7,600,000 of principal, plus nearly $2,000,000 of accumulated income, a total of nearly $10,000,000. A complete list of investments was not introduced at the trial, but the trustee's ledger sheets reflecting the transactions during the tax year disclose that the funds were invested in at least sixty-five different bond issues aggregating $3,500,000 face amount and at least eighteen different stocks aggregating 85,000 shares, a total of eighty-three different income-producing securities (R. 125-156).

The trustee was given wide discretionary investment powers and was not restricted to so-called legal trust fund investments prescribed by the New York statutes (R. 89-90). The trustee was authorized to retain the investments received from the testator and was admonished that the property should be managed prudently and securely, "rather than hazarded in what may promise great gains" (R. 78). In a decree construing the will, the Surrogate instructed the trustee that it was its duty to "at all times exercise keen and alert judgment with respect to" the investment and reinvestment of the trust funds (R. 90).

The combined trust income of both trusts in 1931 amounted to over $250,000, of which, after deducting distributions made for the support of the beneficiaries, over $230,000 was accumulated for their benefit (R. 67, 68). The figures for 1930 do not appear in the record, but up to the end of 1929 the trust income aggregated over $1,900,000, of which over $1,700,000 was accumulated and invested (R. 85, 87).

During 1931 the trustee made at least 47 security

transactions, including 22 purchases, 19 sales and 6 redemptions (R. 125-156). The transactions during the earlier years do not appear in the record.

The Board found (R. 36):

> "The duties of the petitioner as trustee of the trusts consisted in general of causing its investment committee to review several times each year the securities comprising the corpus of the trust; selling securities and reinvesting the proceeds in other stocks and bonds; collecting interest and dividends on securities; paying expenses of the trusts; distributing income to beneficiaries; keeping the books of account of the trusts; rendering statements to the interested parties; and preparing and filing income tax returns."

The Trust Officer in charge of the account testified that the investments held in these trusts were reviewed at least 2 to 4 times a year by an investment committee, in addition to weekly or monthly reviews by the investment clerk and the senior officer in charge (R. 107). In 1930 the trustee filed an intermediate accounting for the purpose of securing the Surrogate's instructions as to its investment powers and duties (R. 112).

Under Section 285 of the New York Surrogate's Court Act, printed in the Appendix, a trustee is entitled to receive "for his services in such official capacity" commissions as follows: "for receiving and paying out all sums of money not exceeding $2,000 at the rate of five per centum", and "for receiving and paying out any additional sums" at lower graduated rates. Commissions computed on the amount of income received and paid out may under certain

conditions be deducted from the income and paid to itself by the trustee. Commissions computed on the amount of principal received and paid out are allowable only on judicial settlement of the trustee's accounts.

Pursuant to the authority of that statute, the trustee has withheld from the trust income and paid to itself commissions computed on the trust income. In the tax returns which it ~~has filed~~ for the trusts such commissions have been claimed as deductions in computing the net income of the trust, and such deductions have uniformly been allowed by the Commissioner of Internal Revenue without question (R. 103, 111).

No commissions computed on the principal of the trusts were claimed by the trustee or allowed or paid to it until 1931, when its first judicial accounting was approved by the Surrogate's Court of New York County (R. 66, 87, 88). In that accounting the trustee was allowed commissions computed on principal amounting to $38,641.71 in the Anthony N. Duke Trust and $38,641.06 in the Angier B. Duke, Jr., Trust, which commissions it paid to itself and charged to the principal of the trusts as required by the decree (R. 66, 67).

The trustee did not claim deductions for the commissions computed on and paid out of principal, on the income tax returns which it filed for the trusts for 1931. However, deductions for such commissions were claimed in the trustee's petitions to the Board of Tax Appeals from the Commissioner's determinations of deficiencies in the 1931 tax (R. 8, 19).

At the trial of the cases before the Board, counsel for the respondent conceded that the trustee's ordinary income commissions (and all other ordinary and necessary business expenses of the trust) were allow-

able (R. 103). He urged that the commissions in issue should not be allowed because they were not proper income charges, but represented large, unusual items of a capital nature which were computed on the basis of and paid out of the corpus of the trusts, and he stated that, therefore, previous rulings by the Treasury and the Board allowing deductions for trustees' commissions as business expenses were distinguishable (R. 103, 104).

Despite the concession which he had made at the trial, counsel for the respondent urged, in the brief which he filed after the trial, that the administration of the trusts did not constitute a business, and that the trustee was not entitled to deduct any business expenses, and that the commissions in issue should be disallowed on that ground as well as on the ground relied on at the trial.

Rulings Below.

The Board of Tax Appeals sustained the Commissioner. Seven members of the Board concurred in an opinion disallowing the commissions solely on the ground that the trustee's administration of the trusts was not a business (R. 36). Four members, in a separate opinion, concurred in that holding but also justified the disallowance of the commissions on the ground that they were "non-recurring items chargeable to and deductible from corpus" (R. 42). Five members dissented (R. 42, 43).

The Court of Appeals affirmed, saying:

"We hold that in caring for the trust estate the trustee was like an individual engaged in investing his funds in stocks and bonds and that

such a person cannot be regarded as engaged in business and, therefore, is not entitled to be allowed any deduction for expenses incurred in investing and supervising the estate" (R. 178).

"In spite of the practice of the tax department to treat such a trustee as though engaged in business we see no rational ground for distinguishing his position from that of a guardian, custodian or individual investor * * *" (R. 180).

Specification of Errors.

The Circuit Court of Appeals erred:

1. In holding that the administration of the trusts was not the conduct of business within the meaning of Section 23(a) of the Revenue Act of 1928.

2. In upholding the Commissioner's contention that the administration of the trusts was not the conduct of business, despite the Commissioner's concession to the contrary at the trial.

3. In holding that the trustee's commissions in question were not "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business", within the meaning of said section.

4. In ignoring the long-established and consistent administrative practice under which such commissions have been allowed as business expenses, and in failing to consider such practice controlling on the interpretation of the statute.

5. In approving the Commissioner's disallowance

of the commissions in question and in affirming the decisions of the Board of Tax Appeals disallowing the claimed deductions.

Summary of Argument.

The respondent's concession at the trial, that certain items were deductible as business expenses in computing the net income of the trusts, constituted an admission that the administration of the trusts was a business. This concession removed that issue from the case. The respondent should not have been permitted, after the trial, to repudiate his concession and re-inject that issue into the case.

"Ordinary and necessary" trustees' commissions have always been allowed as "business" expenses, under a settled and uniform administrative practice which has been followed, without substantial deviation or challenge in the Board or the courts, from the inception of the income tax laws until after the trial of these cases in the Board. While this administrative practice has been in effect, the statutory provision allowing deductions for ordinary and necessary business expenses has been reenacted twelve times. These repeated reenactments of the provision indicate Congressional approval of the administrative practice and have given to it the force and effect of law.

The administrative practice is sound, and should be approved. The decision in *Higgins* v. *Commissioner,* decided February 3, 1941 (No. 253), involving personal investment activities of an individual, is distinguishable. Here, the trusts were separate legal and taxable entities, and the trustee was administering the trust estates for the benefit of others. There-

fore, the commissions of the trustee and the other expenses of administering the trusts cannot possibly be regarded as "personal" expenses.

The trusts were established for the investment and reinvestment of a large sum and accumulating and reinvesting the income therefrom, thus building up an ever increasing fund. Investment activities of that nature, when carried on by a corporation or a trust, have often been held to constitute the conduct of business.

The disallowance of trustees' commissions as "business" expenses would produce difficult complications, and would result in only a slight increase in the public revenues.

The commissions here in issue should not be disallowed merely because they were computed on the basis of and paid out of principal of the trust funds. Such commissions were paid for the trustee's care and management of the trusts, and not for the mere act of receiving the principal. They differ in no respect from the commissions paid on income, which the respondent conceded are allowable deductions. An item otherwise deductible in computing net income taxable to a trust as an entity may not be disallowed just because it is charged against principal instead of income of the trust.

Argument.

I.

The respondent is bound by his concession at the trial that the ordinary and necessary expenses of the trust, including the trustee's commissions on income, are allowable deductions.

The commissions in issue, which were computed on and paid out of the trust corpus, were claimed as deductions in the trustee's petitions to the Board. The respondent's answers to the petitions pleaded general denial and thus raised the broad, general question of whether the commissions in issue were (1) ordinary and necessary expenses, (2) incurred in business.

The question of whether the commissions were "business" expenses was, therefore, within the issues framed by the pleadings, as well as the question of whether the commissions were "ordinary and necessary" expenses.

However, at the trial, the respondent's counsel, in his opening statement, conceded on the record that the trustee was entitled to deductions for business expenses, such as the usual commissions computed on and paid out of trust income, and he said that all such expenses had been allowed by the Commissioner. He then added that the respondent contended that the commissions in issue were not allowable because they were large, unusual items paid for the trustee's act of receiving the trust corpus in 1926, were not connected with the production of trust income but were paid out of the corpus of the trusts and that, therefore, the previous rulings by the Treasury and the Board allowing deductions for trustees' commissions as business expenses were distinguishable (R. 103-104).

By this concession on the record, the issue in the cases was narrowed and precisely defined, and any question as to whether the administration of the trust constituted a business within the meaning of Section 23(a) was abandoned by the respondent and thus removed from the cases.

In *Helvering* v. *Wood,* 309 U. S. 344, this Court held that the Commissioner could not on appeal abandon a concession made at the trial *on a pure question of law*, and "shift to ground which the taxpayer had every reason to think was abandoned", even though the facts were not in dispute and although this Court said that, but for the concession, it would have upheld the contention which the Commissioner later sought to urge in disregard of his concession.

It is true that, in the *Wood* case, the Commissioner did not attempt to repudiate his concession until the case was on appeal, whereas here he attempted to repudiate it in his brief in the Board. However, issues must be raised before or at the trial of a case, not after the trial. The decision in the *Wood* case is fully applicable to the situation presented here. *General Utilities & Operating Co.* v. *Helvering,* 296 U. S. 200.

LeTulle v. *Scofield,* 308 U. S. 415, and *Helvering* v. *Gowran,* 302 U. S. 238, are not in point. In the *LeTulle* case, the issue on which the case was decided in the Supreme Court had been properly raised and insisted on in the Board. In the *Gowran* case, this Court pointed out that the appellant in the Court of Appeals had not objected to that court's consideration of the new issue which the appellee raised there for the first time.

The petitioner was entitled to know at or before the trial the issues upon which the cases would be

submitted to the Board, and, therefore, the respondent should not be permitted to repudiate after the trial the concession which his counsel made on the record at the trial.

II.

The settled administrative practice, pursuant to which trustees' commissions have uniformly been allowed as business expenses, has been approved by Congress through repeated reenactment of the statute.

The Court of Appeals conceded that the administrative practice has been to allow trustees' commissions as "business" expenses, but refused to give effect to the practice solely for the reason that it has never been set forth in a Regulation or Treasury decision issued by the Secretary of the Treasury.

The holding of the Court of Appeals on that point was clearly erroneous.

A Regulation or Treasury Decision may be the best evidence of a uniform and consistent administrative practice, since it will be presumed that the instructions of the Secretary as set forth therein have been obeyed consistently by all subordinates of the Department in their adjustment of the cases handled by them. But it does not follow that administrative practice cannot be proved otherwise than by Regulations or Treasury Decisions. Where departmental rulings have applied the same principle uniformly and consistently in case after case over a long period of time and where such rulings are not in conflict with any general Regulation or Treasury Decision, they are adequate proof of the administrative practice, and have been accepted as such by this Court. *Helvering* v. *Bliss*, 293 U. S. 144, 151; *McFeely* v. *Commissioner*, 296 U. S. 102, 108.

In *Higgins* v. *Commissioner, supra,* this Court again recognized that rulings of the Bureau of Internal Revenue, not issued by the Secretary of the Treasury, may constitute sufficient evidence of a settled administrative practice. The Court, in holding that the rulings in that particular case did not establish "a fixed administrative construction" of the statute, pointed out that the Commissioner had advanced contentions contrary to such rulings in a number of cases in the Board and the courts. The Court said:

> "Unless the administrative practice is long continued and substantially uniform in the Bureau and without challenge by the Government in the Board and courts, it should not be assumed, from rulings of this class, that Congressional reenactment of the language which they construed was an adoption of their interpretation."

The administrative practice on the allowance of trustees' commissions fully meets the tests laid down in the *Higgins* case.

So far as we have been able to ascertain, there never has been a case since the enactment of the Revenue Act of 1913 in which trustees' commissions have been disallowed by the Commissioner on the ground that the administration of the trust did not constitute the conduct of business within the meaning of the statutory provision allowing the deduction of business expenses.

Literally hundreds of thousands, possibly millions, of income tax returns have been filed by trustees under the various revenue acts, on which deductions for the trustees' commissions have uniformly been claimed and allowed, as matter of law, entirely irrespective of the nature or extent of the trustees' duties or activities.

The practice of allowing trustees' commissions as business expenses has been evidenced by various Bureau rulings, and there never has been any deviation therefrom:

S. O. 88, 4 C. B. 119;
I. T. 1393, I-2 C. B. 83;
S. M. 2463, III-2 C. B. 91;
I. T. 3163, 1938-1 C. B. 202;
Letter Jan. 16, 1931, from J. C. Wilmer, Deputy Commissioner, to the Corporate Fiduciary Association of New York (Prentice-Hall 1939 Federal Tax Service, p. 7.135).

Those rulings were approved, necessarily albeit impliedly, by the Board in a number of cases in which the Commissioner unsuccessfully contested the allowance of commissions of fiduciaries, or other expenses incurred by estates or trusts, on the ground that they were not "ordinary and necessary" expenses, or were capital expenses, or were chargeable against non-taxable income, or were estate administration expenses allowable only as estate tax deductions. See, for example, *Knox* v. *Commissioner,* 3 B. T. A. 143 (Acq. V-1 Cum. Bull. 3); *Bendheim* v. *Commissioner,* 8 B. T. A. 158 (Acq. VII-1 Cum. Bull. 3); *Franklin* v. *Commissioner,* 11 B. T. A. 148; *Mead* v. *Commissioner,* 6 B. T. A. 752 (Acq. VII-2 Cum. Bull. 26); *Seligman* v. *Commissioner,* 10 B. T. A. 840 (Acq. VII-2 Cum. Bull. 36); *Grandin* v. *Commissioner,* 16 B. T. A. 515; *Ames* v. *Commissioner,* 14 B. T. A. 1067 (Acq. VIII-2 Cum. Bull. 2); *Chicago Title and Trust Co.* v. *Commissioner,* 18 B. T. A. 395; *Griffin* v. *Commissioner,* B. T. A. Memo. Opinion (No. 10,769-G, C. C. H. B. T. A. Service).

The Commissioner did not contend in any of those cases or in any other case, except as stated below, that the administration of the estate or trust was not a business. However, in 1937, after the practice of allowing trustees' commissions as business expenses had been followed without question for twenty-four years, counsel for the Commissioner, in *Watson* v. *Commissioner,* 35 B. T. A. 706, objected to the allowance of commissions in his brief, on the ground that the administration of the trust was not a business; but the Board overruled that objection, whereupon the Commissioner promptly published notice of his "acquiescence" in the decision (1937—1 C. B. 6, *sub nom Corrigan Estate*).

Never before or since that time, except in the instant cases (so far as we have been able to ascertain), has the Commissioner or his counsel challenged the general practice of allowing trustees' commissions as business expenses of an irrevocable trust, provided it appeared that they were "ordinary and necessary" commissions.[1]

---

[1] In the case of revocable trusts, the Commissioner has attempted in recent years to allocate the trustee's commissions between taxable income and tax-exempt income, and to disallow the portion thereof allocated to tax-exempt income, just as he has done with respect to investment expenses of individuals (See pp. 9-12 of the brief of the undersigned as *Amicus Curiae,* in the *Higgins* case). If it be assumed that such an allocation is justified in the case of an individual, it also may be justified in the case of a revocable trust, because a revocable trust is ignored for tax purposes, or treated as a mere agency, and all the income and deductions are taken on the grantor's return (Sec. 166, Int. Rev. Code; Sec. 19.166-1, Reg. 103). And in *Elliott* v. *Commissioner,* a B. T. A. unreported memorandum decision handed down on November 27, 1939 (C. C. H., B. T. A. Service, Dec. No. 10,931-A), where the trustee of a revocable trust opposed such an allocation, counsel for the Commissioner contended on the trial that no part of the commissions should be allowed, and the contention was sustained by the Board and

(Footnote continued on following page.)

During the period of more than a quarter of a century while this practice has been in effect, the statutory provision allowing deductions for ordinary and necessary business expenses has been re-enacted without material change on twelve occasions.

These repeated reenactments of the statute indicate Congressional approval of the settled administrative interpretation and have, indeed, given to it the force and effect of law. *Helvering* v. *R. J. Reynolds Tobacco Co.*, 306 U. S. 110, 115.

III.

The administrative practice is sound and should be upheld.

Aside from the concession made by counsel for the Commissioner at the trial, the facts in the record show that the trustee was regularly engaged in the active investment and reinvestment of the trust funds, the accumulation of the income therefrom and the continuous investment of such accumulations. Such activities, requiring constant care, attention, judgment and action, pursued over a period of years, starting with a trust fund of nearly $8,000,000 which is being increased at the rate of nearly a quarter of a million dollars a year, constitute active, continuous

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thereafter by the Circuit Court of Appeals for the Third Circuit on February 21, 1941 (Prentice-Hall Fed. Tax Service for 1941, p. 62,501).

In the case of irrevocable trusts, where the beneficiaries are nonresident aliens, a similar allocation has been made by the Commissioner (I. T. 3163, 1938—1 Cum. Bull. 202). Although there have been sporadic attempts to make such an allocation in the case of income of irrevocable trusts distributable to resident or citizen beneficiaries, the Board has held that allocation is not permissible in such cases. See *Watson* v. *Commissioner*, *Knox* v. *Commissioner*, *Griffin* v. *Commissioner*, all *supra*.

business within any generally accepted meaning of the term.

The will here involved authorized the trustee to retain investments acquired from the testator and admonished it to be more concerned over the safety of principal than securing a high income yield through hazardous ventures. But the ~~will conferred~~ on the trustee unlimited discretion as to investments and re-investments and the Surrogate directed it to "at all times exercise keen and alert judgment with respect to same". Moreover, the trustee was directed during the minority of the beneficiaries to accumulate and invest all income not required for their support. The fund aggregated nearly $10,000,000 during the year in question, spread among at least 83 different income-producing securities, of which nearly $2,000,000 represented invested income.

The trustee did everything necessary and proper to perform its duties as the administrator of the testator's fortune. Apparently, the trustee was conservative in investing and re-investing the funds. So far as the record discloses, it made comparatively few changes in investments and no in-and-out transactions for speculative profits, but it repeatedly reviewed the investments, constantly studied business, financial and market conditions, and generally exercised unremitting vigilance. At the same time, it regularly invested accumulated income at the rate of nearly a quarter of a million dollars a year.

The decision in *Higgins* v. *Commissioner,* in which this Court refused to overrule a determination of the Commissioner, approved by the Board, that the regular and continuous activities of an individual in looking after his own investments did not constitute the carrying on of trade or business within the mean-

ing of Section 23 (a), does not require the overruling of the administrative practice of allowing trustees' commissions as business expenses.

In cases where individuals claim deductions for the expense of looking after personal investments, it is difficult to draw the line between expenses which properly may be treated as business expenses and expenses which are of a personal nature, incurred for the mere convenience of the taxpayer. It must be conceded that under certain circumstances an individual investor could do everything necessary to care for his own investments and collect the income therefrom, without incurring the expense of maintaining an office and employing assistants. Although the investments of a very wealthy individual may be so extensive and varied as to make it impossible for him to handle them properly without expense, the difference is only one of degree, and therefore it may be reasonable to conclude that such expenses, even where actually required, are nothing but personal expenses, which are expressly disallowed by the statute.

In the case of a trust, no such consideration is involved. The trustee—the trust estate—can have no personal expenses. There is no individual for whose personal convenience any expenses can be incurred. Unlike an individual investor, the trustee manages the trust funds for the benefit of others.

The trust is a legal and taxable entity, separate from the personality of the testator and the beneficiaries. That distinguishes these cases from *Van Wart* v. *Commissioner,* 295 U. S. 112, involving a guardianship, which this Court held is not an entity. The decision in the *Van Wart* case might be applicable to a revocable trust, which is not recognized as an entity for income tax purposes, but it

should not be applied to an irrevocable trust, and especially a testamentary trust, such as the trusts here involved.

This court said in *Edwards* v. *Chile Copper Company,* 270 U. S. 452, that to say that a corporation is not engaged in business is "pretty nearly equivalent" to saying it is "not pursuing the ends for which the corporation was organized, in the cases where the end is profit". That observation applies equally to a trust established for the investment and reinvestment of principal and income accumulations.

Moreover, the trusts in these cases were created for the purpose of accumulating and reinvesting the trust income and thus building up an ever increasing fund. The accumulation and reinvestment of income, instead of its mere collection and distribution, always has been considered an attribute of business activity. See Article 43, Regulation 64; *Flint* v. *Stone Tracy Co.,* 220 U. S. 107, 171.

A corporation formed for the purpose of accumulating and reinvesting the income from capital assets would meet the test of "business" laid down in the Corporation Excise Tax Act of 1909 and the various capital stock tax acts, which impose excise taxes on the privilege of doing business. *Stanley Securities Co.* v. *United States,* 38 F. (2d) 907 (Ct. Cls.), cert. den. 282 U. S. 845; *Phillips* v. *International Salt Co.,* 274 U. S. 718.

Trusts organized in *quasi* corporate form for the purpose of investment and reinvestment have been held subject to corporation income taxes on the ground that they were engaged in business. *Brooklyn Trust Company* v. *Commissioner,* 80 F. (2d) 865 (C. C. A. 2), cert. den. 298 U. S. 659; *City Bank Farmers*

Trust Company v. *Graves*, 272 N. Y. 1; *Ittleson* v. *Anderson*, 67 F. (2d) 323 (C. C. A. 2); *Sears, Roebuck & Co., etc.* v. *Commissioner*, 45 F. (2d) 506 (C. C. A. 7).

The disallowance of the trustee's commissions as deductions in computing the net income of a trust under the income tax law would produce difficult complications and would result in only a slight increase in the public revenues.

The beneficiary of a trust is taxable only on the net income which is either actually distributed to him or currently distributable to him under the provisions of the trust instrument (Sec. 162). The portion of the trust income which is used to pay the commissions of the trustee is not distributable to the beneficiary and, of course, is not distributed to him. Therefore, that portion of the income cannot be taxed to the beneficiary, even if it is disallowed as an income tax deduction.

The only way in which the income tax could be imposed on the trust income used for the payment of trustee's commissions would be to treat it as undistributed trust income, taxable to the trustee [Sec. 161 (b)]. Obviously, the trustee would have the right, in such a case, to provide himself with the money necessary to pay that tax, by withholding a further amount from the beneficiary, whose taxable income would thereby be further reduced.

But the amount of the trustee's tax on the income used to pay the trustee's commission, having been properly withheld from the beneficiary, would itself have to be added to the income on which the trustee would be required to pay tax. That would increase the trustee's tax by a further amount, which in turn

would have to be withheld from the beneficiary, and so on, down to a fraction of a penny.[2]

So far as trustees' commissions computed on income are concerned, the additional taxes which the Government would receive by the disallowance of such commissions as deductions would be insignificant in amount in the vast majority of cases, where the only "income" taxable to the trusts as separate entities would be the portion of the trust income used to pay the commissions.

Under New York law, the trustee's commission on $100,000 of income is only about $2,000, and the tax on $2,000 which the trust would be compelled to pay would amount, at present rates, to only $76. On income of $10,000, the commissions are only about $200, and the tax on $200 is only $4.

Where, as in these cases, the trust income is accumulated, rather than being currently distributable, the income used to pay commissions would be added to the net income accumulated for the beneficiaries, and taxed at the highest applicable rates.

The effect of allowing, or of disallowing, the deduction of commissions computed on and paid out of corpus will be discussed in our next point.

It is submitted that the uniform, settled administrative practice of allowing trustees' commissions as business expenses represents a sound, practical interpretation of the applicable provision of the various revenue acts and should be sustained.

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[2] The problem just referred to would not arise, of course, where, as in the instant cases, all the trust income is accumulated in the trust, instead of being distributable to the beneficiaries, and therefore is taxable to the trust estate as a separate entity. However, it would arise in the far more numerous class of cases in which the trust income is currently distributable to the beneficiaries.

IV.

The commissions in issue, which were computed on and paid out of trust corpus, are nevertheless deductible as "ordinary and necessary" expenses.

The objections specified by Government counsel at the trial to the allowance of the commissions in question were not considered at all by seven members of the Board. Of the other nine members, four were of the opinion that those objections were well taken, while five thought otherwise.

The Court of Appeals based its decision entirely on its holding that the trusts were not entitled to any deductions for "business" expenses. As to whether the commissions in question should be disallowed merely because they were computed on and paid out of trust corpus, the Court of Appeals said that it "might be permissible" to deduct them if the trust were entitled to any "business" deductions.

The commissions of testamentary trustees in New York are computed and paid pursuant to the provisions of Section 285 of the Surrogate's Court Act (printed in the Appendix) which allows commissions computed on the basis of a percentage of the amounts of principal and income received and paid out. The statute provides that the commissions are allowed to the trustee "for his services in such official capacity". It makes no distinction between commissions computed on the basis of principal and those computed on the basis of income; the amounts of principal and income paid out are merely the basis or yardstick for measuring the trustee's compensation.

In *Collier* v. *Munn,* 41 N. Y. 143, the New York Court of Appeals said, at p. 147, that it was the "obvious intent" of the New York statute "to make the sums, called commissions, compensation, not for the service of receiving and paying, but compensation for the whole services *measured* by a *fixed standard*". (Italics the court's.)

This was made clear in *Matter of Bushe,* 227 N. Y. 85. In that case, one of three trustees of a testamentary trust died within two years after the death of the testator. On a subsequent accounting, the Surrogate allowed the two surviving trustees full commissions computed on the basis of principal received, but allowed the estate of the deceased trustee only one-half as much, saying that trustees are not entitled to commissions "for the mere act of receiving property", but that "such commissions are allowed for the services of legal representatives in taking care of, investing and reinvesting such property and for the responsibility connected therewith".

The decision was affirmed by the Court of Appeals, which said that "commissions are allowed for the care and management of the estate and not for the simple act of receiving and paying out". The Court of Appeals also quoted with approval from *Matter of Welling,* 51 App. Div. 355, the statement that "commissions are allowed to trustees as compensation for services in the execution of a trust".

The Commissioner insisted below that the commissions in question were paid to the trustee solely for the act of receiving the trust corpus, a single ministerial act performed in 1926, and that the liability to pay such commissions was fully incurred at that time, since the trustee could have secured them im-

mediately upon the creation of the trust, merely by applying to the Surrogate.

The New York law is entirely different. As has been shown, commissions on principal, just like commissions on income, are allowed the trustee for the performance of all its duties in managing and preserving the trust fund. They are not payable for the mere act of receiving or paying out principal. Whether or not a trustee can secure, immediately after the creation of a trust, any part of the commissions computed on principal depends entirely on the discretion of the court. Under the New York law, the trustee's right to the commissions in issue did not accrue until they were approved by the proper court on a judicial settlement of the trustee's accounts. *Matter of King*, 121 Misc. 530. See *Estate of McGlue* v. *Commissioner*, 41 B. T. A. 1199.

It is clear that trustees' commissions computed on the basis of principal may not be distinguished in any way from those computed on the basis of income and that all such commissions are paid to the trustee for precisely the same services, viz., the administration of the trust throughout its existence.

The fact that the commissions were in part payment for the services of the trustee from the inception of the trusts does not prevent their deduction in full in the year in which they accrued and were paid. *Lucas* v. *Ox Fibre Brush Co.*, 281 U. S. 115.

It is immaterial that the commissions were not an expense of an annual or recurring nature. Even though an expense may be unique in the life of a business, if it is one which is ordinarily and customarily incurred and paid by those engaged in such business, it is deductible under the statute. *Welch* v.

Helvering, 290 U. S. 111, 114; *Kornhauser* v. *United States*, 276 U. S. 145. Where, as here, the taxpayer is on the cash basis, income must be returned in the year of receipt and deductions taken in the year of payment, because the revenue acts assess the income tax on the basis of annual receipts and disbursements. *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359; *Burnet* v. *Thompson Oil & Gas Co.*, 283 U. S. 301.[3]

The fact that the commissions were charged against principal does not justify their disallowance as deductions. We are not concerned here with the question of whether a trust *beneficiary* may claim as a deduction *against trust income actually distributed* to him an expense of the trust which was charged against principal and which thus did not reduce the amount distributed.

In the instant cases the tax has been imposed on the trustee as fiduciary, on the basis of the undistributed net income of the trust. Section 162 of the Revenue Act of 1928 provides that in such cases "the net income of the estate or trust shall be computed in the same manner and on the same basis as in the case of an individual". See *Freuler* v. *Helvering*, 291 U. S. 35, 41.

The income tax law, in allowing certain deductions in computing the net income of estates and trusts, makes no distinction between items which are paid out of income and those which are paid out of corpus. For example, estate taxes, which formerly were allowable as income tax deductions, are payable out of the corpus of the estate, but that

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[3] Fire insurance premiums covering a number of years are deductible when and as they are paid, where the taxpayer makes his returns on the cash basis. *Welch* v. *Deblois*, 94 F. (2d) 842 (C. C. A. 1); G. C. M. 20307, 1938—1 Cum. Bull. 157.

fact did not prevent their being taken as deductions in computing the estate's net income. *United States* v. *Woodward,* 256 U. S. 632, affirming 56 Ct. of Cls. 133. Similarly, losses sustained on sales of capital assets by an executor or trustee are allowable deductions in computing the net income taxable to the estate or trust, although such losses are charged against corpus rather than income. The fiduciary returns which the petitioners filed for the year in question (R. 121-124) show on line 6 that deductions were claimed on account of capital losses which were chargeable to the principal of the trusts, and such deductions were allowed by the respondent without question.

Other examples are bad debts and depreciation on real property. Where, as in this case, the trust income is accumulated, the trustee is entitled to deduct depreciation in computing any net income taxable to it, although under the terms of the trust instrument no depreciation is charged in determining the amount of the trust income which is to be accumulated and thus the depreciation actually sustained depletes the corpus of the trust.

The income tax law always has taxed to the trustee, as one fund, all income not distributed or currently distributable to beneficiaries. The law never has divided the taxable income of a trust into two separately taxable funds, one consisting of the trust income which is being accumulated and the other of the capital gains which form a part of the corpus, even though the accumulated income and the corpus eventually will go to different beneficiaries. Also, in computing the net income which is taxable to the trustee, the law by express provision permits the trustee to deduct all items which would be deductible if the trustee were an individual. No distinction is drawn

between deductions which are chargeable against trust income and those which are chargeable against trust corpus.

The trust is a legal and taxable entity wholly distinct from its beneficiaries (*Anderson* v. *Wilson,* 289 U. S. 20); and where the trust income is not distributable or distributed, but is taxable to the trustee, state laws governing the trustee's accounting as between the classes of beneficiaries who will receive the trust assets do not govern in determining the income tax deductions. The income tax laws have their own criteria for determining income and deductions. *Weiss* v. *Wiener,* 279 U. S. 333, 337; *Heiner* v. *Mellon,* 304 U. S. 271, 279; *Greenough* v. *Commissioner,* 74 F. (2d) 25, 26 (C. C. A. 1).

The provision contained in Section 24(b) of the 1928 Act removes all possibility of doubt on this point. That section provides that the trust income taxable *to an income beneficiary* of a trust or an estate "shall not be reduced * * * by any deduction allowed by this Act * * * for the purpose of computing the net income of an estate or trust" (except depreciation and depletion) which is not chargeable against such income beneficiary under the applicable rules of local law. That provision shows that Congress understood that all deductions "allowed by this Act * * * for the purpose of computing the net income *of* [*the*] *estate or trust,"* are allowable, irrespective of whether they are charged against corpus or against income, and that it therefore required an express provision to prevent a beneficiary from claiming a deduction which did not reduce the income distributable to him.

The fact that an expense is charged against the corpus of the trust does not mean that it is a capital

expense, the deduction of which is disallowed by the tax law. A "capital expense" is an investment in an asset or an expenditure which materially adds to the value of an asset or appreciably lengthens its useful life. Expenditures which merely maintain and preserve an asset—such as the salary of a watchman, the fees of a custodian or the commissions of a trustee—cannot be considered capital expenses. Cf. *Duffy* v. *Central Railroad,* 268 U. S. 55; *Illinois Central Railroad Co.* v. *Commissioner,* 90 F. (2d) 458 (C. C. A. 7).

Heretofore, the Bureau has not attempted to draw any distinction between commissions computed on and paid from principal and those computed on and paid from income. In S. M. 2463, III-2 C. B. 91 (December, 1924) it was ruled that trustees' commissions computed on corpus as well as those computed on income are deductible as business expenses, and the Bureau quoted with approval the earlier holding in S. O. 88, 4 C. B. 119, that:

> "It is immaterial whether the expenses are paid from the corpus of the estate or from income. The expenses derive their character not from the funds out of which they are paid, but from the purposes for which they are incurred."

See, also, the letter of Jan. 16, 1931, from the Deputy Commissioner to the Corporate Fiduciary Association of New York, cited, *supra,* p. 15).

The repeated re-enactment of the provision allowing expense deductions indicates Congressional approval of that administrative interpretation.

The Government appears to believe that there would be something inherently unfair in allowing commis-

sions paid for the services of the trustee over a period preceding the year in which they are paid, as a deduction against one year's income of the trust. The Government is right, but the allowance of the deduction on that basis, as claimed herein, is unfair to the trusts, not to the Government.

Obviously, if the trustee's commissions on principal could be spread over a number of years or over the entire life of the trust, and an allocable portion thereof claimed as a tax deduction in each year, thus applying against the highest bracket income of each year, the deduction would be of much greater benefit to the trusts than the deduction of such commissions in their entirety in the year allowed by the court.

But the income tax law does not allow any deductions except in the year in which they accrue or are paid and a New York trustee's commissions on principal do not accrue and may not be paid except when and as allowed by the court.

The fact that the trustee cannot get his commissions on principal regularly, in equal amounts every year, should not defeat the right of the trust estate to whatever smaller benefit it can obtain by deducting such commissions as they are allowed and paid.

Conclusion.

The respondent's concession at the trial that the administration of the trusts was a business and that commissions computed on income are deductible as business expenses removed that issue from the case; moreover, the concession was in conformity with long-established administrative practice, and such practice represents a proper interpretation of the law and should be upheld. The decision in *Higgins* v. *Com-*

missioner, relating to an individual investor, is not controlling in these cases, where the trustee, the taxpayer, managed the estates for the benefit of others, and the estates themselves were separate taxable entities. The commissions in question were ordinary and necessary expenses of the business incurred and paid during the tax year and were paid for the same services as the commissions which the respondent has conceded were business expenses.

The decisions below are erroneous and should be reversed.

Respectfully submitted,

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APPENDIX.

SURROGATE'S COURT ACT OF NEW YORK

§ 285. *Commissions of executor, administrator, guardian or testamentary trustee.*

On the settlement of the account of any executor, administrator, guardian or testamentary trustee, the surrogate must allow to him his just, reasonable and necessary expenses actually paid by him, and if he be an attorney and counsellor-at-law of this state, and shall have rendered legal services in connection with his official duties, such compensation for such legal services as shall appear to the surrogate to be just and reasonable; and in addition thereto the surrogate must allow to such executor, administrator, guardian or testamentary trustee for his services in such official capacity, and if there be more than one, apportion among them according to the services rendered by them respectively.

1. For receiving and paying out all sums of money not exceeding two thousand dollars, at the rate of five per centum.

2. For receiving and paying out any additional sums not amounting to more than twenty thousand dollars, at the rate of two and one-half per centum.

3. For receiving and paying out any additional sums not exceeding twenty-eight thousand dollars at the rate of one and one-half per centum.

4. For all sums above fifty thousand dollars, at the rate of two per centum.

5. The value of any real or personal property, to be determined in such manner as the surrogate may direct, and the increment thereof, received, distributed or delivered, shall be considered as money in making

computation of commissions. But this shall not apply in case of a specific legacy or devise.

6. In addition to the compensation hereinbefore provided the court in its discretion may allow to a guardian of the person a sum of money to be fixed by it and paid by the guardian of the property out of the funds in his hands, which sum shall be for services of such guardian of the person up to the time of such allowance.

7. If an executor acting as trustee, or if a trustee or guardian, is required to receive income and pay over the same, and such executor, trustee or guardian pays over said income and such executor or trustee renders an annual account to the beneficiary; and such guardian files an annual inventory as required by section one hundred ninety of this act, of all his receipts and disbursements on account thereof, he shall be allowed, and may retain, the same commission on the amount of income so accounted for as he would be allowed upon principal on a judicial settlement; if such executor, trustee or guardian does not render such annual account or inventory, nor retain his commissions upon his annual account or inventory, he shall be allowed out of income then on hand, if any, upon his judicial settlement, his commissions upon the total income from any money or property then payable to such beneficiary as unpaid income.

8. If the gross value of the principal of the estate or fund accounted for amounts to one hundred thousand dollars or more, each executor, administrator, guardian or testamentary trustee is entitled to the full compensation on principal and income allowed herein to a sole executor, administrator, guardian or

testamentary trustee, unless there are more than three, in which case the compensation to which three would be entitled must be apportioned among them according to the services rendered by them, respectively. Where the will provides a specific compensation to an executor, administrator, guardian or testamentary trustee, he is not entitled to any allowance for his services, unless by a written instrument filed with the surrogate, within four months from the date of his letter, or in case of a testamentary trustee or guardian, from the date of his filing his oath, he renounces the specific compensation. Where successive or different letters are issued to the same person on the estate of the same decedent, including a case where letters testamentary or letters of general administration, are issued to a person who has previously been appointed a temporary administrator, he is entitled to a total compensation equal to the compensation allowed for the full administration of the estate by a fiduciary acting in a single capacity only. Such total compensation shall be payable in such proportions and upon such accounting as shall be fixed and allowed by the surrogate settling the account of the person holding such successive or different letters but no paying out commissions shall be allowed except upon such sums as shall have been actually paid out at the time of the respective decrees for debts, expenses of administration or to legatees or other beneficiaries.

9. Where an executor, administrator, guardian or testamentary trustee is, for any reason or cause whatsoever, entitled or required to collect the rents of and manage the real property, he shall be allowed and may retain five per centum of the rents collected therefrom in addition to the commissions herein provided.